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No. 410

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IN THE

SUPREME COURT OF THE UNITED STATES

OCTOBER TERM, 1944

IN THE MATTER OF PROPOSED REORGANIZATION OF THE WESTERN TOOL & MANUFACTURING COMPANY, A CORPORATION,
Debtor.

OWEN N. PRICE, Trustee for Bondholders of The Western Tool & Manufacturing Co., and Roy Massena, E. J. Price, W. D. Hollister and W. T. Kettering, Bondholders' Protective Committee for Holders of Bonds of The Western Tool & Manufacturing Co.,
Petitioners,

vs.

JAMES G. GURNEY, Individually and on Behalf of Other Shareholders of The Western Tool & Manufacturing Co.,
Respondent.

Petition for Rehearing.

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JAMES G. GURNEY, Individually and on Behalf of Other Shareholders of The Western Tool & Manufacturing Co.,
Respondent.

Petition for Rehearing.

To the Honorable the Chief Justice and the Justices of the Supreme Court of the United States:

Respondent respectfully submits that a rehearing should be granted in this cause because, unquestionably, the result of the Court's opinion is to permit substance to give way to form, fraud to prevail and to allow technical considerations to prevent the doing of substantial justice, the very

consequences which this Court denounced in the case of *Pepper* v. *Litton*, 308 U. S. 295.

The narrow construction placed upon Chapter X of the Bankruptcy Act, whereby the stockholders of a corporation in need of the relief provided by the Act but which its antagomistic directors refuse to seek, are relegated to a state equity court proceeding to require the directors to seek such relief, defeats the very purposes for which the reorganization statute was enacted and for the accomplishment of which jurisdiction was conferred upon the federal courts alone.

The purpose of the Chandler Act was to grant relief to distressed corporations. To postpone the aid afforded by that Act for the period required to litigate, in the trial and reviewing courts of a state, the same questions which would again have to be determined by the federal bankruptcy court, would be, for all practical purposes, a denial of relief to the corporation. Such delays would, in by far the majority of cases, result in the loss of the stockholders' equity value by lapse of time and the hazards of management by a receiver incident to such litigation. When the stockholder had finally succeeded in the state court, not only would the burden of prosecuting the reorganization proceedings still fall upon him, because of the antagonism of the directors, but he would be required again to prove in the bankruptcy court (as the Security and Exchange Commission pointed out in its memorandum page 11), (1) that reorganization is needed, (2) that the stockholders have an equity which is threatened with impairment or destruction by the action of the directors and (3) that the stockholders have filed their application in good faith.

Neither in Section 126 of Chapter X, nor elsewhere, did Congress provide the internal procedure which a corporation must follow before it may seek relief under that

Chapter. Except as required by the instant decision of this honorable Court, there is no requirement created that a corporation can seek such relief *only* after action of its board of directors.

In this case the respondent advanced two contentions: One, that the directors are antagonistic and fraudulently refuse to act, the other, that the corporation is without a board of directors which can act for it. This Court has held, with respect to the first contention, that the federal court can grant no relief under Chapter X because the directors have refused to take formal action to seek that relief. This holding was based upon the extremely narrow ground that, under the Ohio corporation statute, a corporation's powers are vested in its board of directors. Wholly ignored are the decisions of the Ohio courts that when the actions of the directors of a corporation are so motivated, the stockholders, themselves, are empowered to institute legal proceedings, in behalf of the corporation, to preserve its assets. *Henry* v. *Jeanes, et al.*, 47 O. S. 116; *Godin* v. *Cincinnati & M. Canal Company*, 18 O. S. 169; *Buckeye Garage Company* v. *Caldwell*, 18 C. C. (N.S.) 429 (Ohio); *Jensen* v. *Republic Steel Corporation*, 32 Ohio Law Abstract 29; *Garage & Sales Co.* v. *Caldwell*, 18 O. C. C. (N.S.) 429; *Larwill* v. *Burke*, 19 O. C. C. 449 (aff. in 66 O. S. 683).

Whether it is a misnomer to designate such proceeding a derivative action because it is not the assertion of a corporate defense against a third party's claim nor the seeking of relief against a third party, would not seem to be determinative. It may well be said, however, that a Chapter X proceeding is an action by a corporation against its creditors for the readjustment of their claims and rights *inter se*. But whatever it may be termed, it remains an action to obtain the relief provided by the Bankruptcy Act and to preserve the corporation as a going concern. The federal bankruptcy courts have, in

numerous cases, exercised their equitable powers to afford shareholders relief where the directors refused to seek it or were actively antagonistic to the corporate interests. *In Re Beaver Cotton Mills*, 275 Fed. 498; *Ogden* v. *Gilt Edge Consolidated Mines Co.*, 225 Fed. 723; *In Re Dressler Producing Co.*, 262 Fed. 257; *Zeitinger* v. *Hargadine-McKittrick Dry Goods Co.*, 244 Fed. 719; *Whittiker* v. *Brictson Mfg. Co.*, 43 Fed. (2nd) 485; *United States Lines* v. *United States Lines*, 96 Fed. (2nd) 148.

This Court itself has held that to warrant the exercise of a court's equitable powers in behalf of corporate stockholders, the attitude of the directors need not be sinister but may be sincere but it is enough if the attitude is antagonistic to the company's interest. *Delaware & Hudson Co.* v. *Albany & Susquehana R. R. Co.*, 213 U. S. 435, 451.

Respondent respectfully submits that the fallacy is apparent in reasoning that: (1) before stockholders may be "allowed to put their corporation into bankruptcy, they must present credentials to the bankruptcy court showing their authority"; (2) whether they have such authority is dependent upon local law; (3) local law vests the powers of the corporation in its board of directors except where the directors are antagonistic and refuse to act, in which case the stockholders may exercise the powers of the corporation in its behalf; (4) the directors have refused to act and are admittedly antagonistic; *ergo* the stockholders cannot act on behalf of the corporation because the directors are vested with the powers of management. Yet such is the decision in this case.

The second contention of respondent, that the corporation here involved is without a board of directors who could act for it, was not decided by this honorable Court.

The consequence of the instant decision is that a corporation lacking, for whatever cause, a *de jure* board of directors, would be barred from relief under Chapter X,

for a state court could not appoint directors for it and, as in the instance case, where the majority of the stock is held by antagonistic directors as voting trustees, a state court proceeding would result only in the dissolution of the corporation instead of its preservation.

Further, it is respondent's contention that a proceeding such as respondent's, does not require the federal bankruptcy court to determine any question which it is not otherwise required to determine under Chapter X.

Section 146 (11 U.S.C.A. 546) requires the bankruptcy court to determine whether the petition is filed in good faith. It cannot be gainsayed that one of the questions which must be considered and decided in reaching that determination is whether the corporation is properly before the court. If a corporation filed a voluntary petition for reorganization and a creditor sought its dismissal upon the ground that the corporation lacked a *de jure* board of directors, or that the directors' meeting, at which the filing of the petition was approved, had been illegally held, would the bankruptcy court be without jurisdiction to determine that question? (Cf. *In Re Mississippi Valley Utilities Corporation*, 2 Fed. Sup. 995; *In Re Fidelity Assurance Association*, 42 Fed. Sup. 973, 983. Under such circumstances could the bankruptcy court do nothing but deny relief to the corporation until a state court had determined the legality of the election of directors or of such meeting? To so hold is to abandon the principles of equity to embrace formalism.

To determine whether the corporation is properly before the court the legal principles involved do not vary because that issue is presented by a creditor rather than, as here, by a stockholder. To find, pursuant to Section 146, that the petition is filed in good faith, requires a determination that the corporation is properly before the bankruptcy court and necessarily, therefore, the bank-

ruptcy court is empowered to determine it. To hold otherwise is to discover a prohibition in the Bankruptcy Act which does not, in fact, exist. To place, by judicial interpretation, such a limitation upon the power of the court is not only a negation of the statutory purpose but is directly contrary to this Court's decision in *Taylor* v. *Standard Gas Co.*, 306 U. S. 307, 322, that equitable principles will be applied in a reorganization proceeding and, if necessary to prevent injustice, the corporate entity will be disregarded.

We respectfully submit that for the reasons above stated a rehearing should be granted and the decision of the Circuit Court of Appeals affrmed.

Respectfully submitted,

CHARLES W. STIEFEL, JR.,
77 W. Washington Street,
Chicago, Illinois;

GEORGE R. MURRAY,
Callahan Building,
Dayton, Ohio,
Attorneys for Respondent.

I, Charles W. Stiefel, Jr., one of the attorneys for respondent in the above cause, hereby certify that the foregoing petition for rehearing is filed in good faith and not for purpose of delay.

CHARLES W. STIEFEL, JR.

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No. 410

October Term, 1944

OWEN N. PRICE, Trustee for Bondholders of The Western Tool & Manufacturing Co., and ROY MASSENA, ET AL., Bondholders' Protective Committee, etc.,

Petitioners,

vs.

JAMES G. GURNEY, Individually, etc.,

Respondent.

MEMORANDUM IN OPPOSITION TO PETITION FOR REHEARING

The Petition for Rehearing is based simply on the claim that this Court was wrong in the decision and the opinion erroneous in argument. The burden of counsel's complaint of the decision is that it is an "extremely narrow" construction of the law. We do not undertake to justify the opinion, for it justifies itself, nor do we presume to add to or improve on the argument.

It is said that decisions of Ohio Courts hold that when directors are antagonistic and fraudulently refuse to act "the stockholders, themselves, are empowered to institute legal proceedings, in behalf of the corporation, to preserve its assets." These decisions only hold that in certain cir-

cumstances stockholders, when the directors refuse to act, may themselves sue or defend on behalf of the corporation to preserve assets or rights. A reorganization proceeding is not to preserve assets or rights of the corporation. It is not an action by the corporation against its creditors or stockholders. No relief is asked nor can be asked for the corporation itself. It is only for and on behalf of the creditors and stockholders.

The failure of stockholders to attend an annual meeting, resulting in a failure to elect directors, cannot of itself create a power in stockholders to act for the corporation. The result of the failure to elect is simply that the old board of directors holds over and there is at least a *de facto* board. The directors in holding over are really *de jure* directors since directors hold office until successors are elected.

We might mention that there are other reasons for reversal of the judgment of the Circuit Court of Appeals than the one passed upon by this Court. These other reasons, while decisive in themselves, were not important after this Court decided the stockholder had no right, under the statute, to file the petition. However, we mention these other points and refer to our briefs on file for reasons in support of same:

1. Neither the corporation nor the directors had any legal duty to file a petition under Chapter X, that being a matter of business judgment. (Brief 24-5, Reply Brief in support of Certiorari 3.) (This point has not been answered or referred to in Respondent's Briefs.)

2. The record shows no misconduct on the part of the directors. (Brief 16-23, 25, Reply Brief in support of Certiorari 2-4.) If there was no legal election of directors, that imposed no duty on directors to file a petition. The record

shows no real controversy about the rate of interest. (Brief 22-3.) At any rate that question was involved in, decided and therefore conclusively adjudicated in the foreclosure case with no intervention on the part of the Respondent. (Brief 23-4, Reply Brief on Merits 3.) The laches of Respondent over a long period of time, particularly during the pendency of the foreclosure suit, prevents any claim thereafter. (Brief 24, Reply Brief in support of Certiorari 6.)

> (We might here suggest that it does appear in the record that the Respondent failed to intervene in the foreclosure proceedings, although having ample notice thereof, except to file a motion to set aside the judgment. (Record pp. 21, 32, 38-9.) Although it does not appear in the record, that motion was denied after the hearing in the District Court and no appeal was taken from that ruling of the state court.)

3. There was and is no reasonable expectation of reorganization under Chapter X because all creditors are definitely opposed. (Brief 27-31, Reply Brief in support of Certiorari 2.)

4. It was not shown that the prior pending proceeding denies to the stockholders in a substantial particular some benefit which Chapter X affords. (Brief 31-2.)

5. The record shows that the corporation was not solvent and therefore stockholders are not interested. (Brief 26-7, Reply Brief in support of Certiorari 7, Reply Brief on Merits 4.)

We note that the opinion mentions that the Respondent may have a meritorious case for relief. We know, of course, that the Court has not examined that matter, but we call attention to the fact that the record shows an honest and

generous management of this Company since 1923 by directors chosen as authorized by the stockholders. The only objection to their conduct is that they were using assets to pay a debt secured by mortgage upon those assets. This policy is denounced as "draining off" the earnings. We suggest they were applied where they belonged and in accordance with the business policy adopted by the directors.

Respectfully submitted,

WM. W. KEIFER,
HORACE S. KEIFER,
Counsel for Petitioners.

SUPREME COURT OF THE UNITED STATES.

No. 410.—October Term, 1944.

Owen N. Price, Trustee for Bondholders of the Western Tool & Manufacturing Co., et al., Petitioners, *vs.* James G. Gurney, Individually and on Behalf of Other Shareholders of the Western Tool & Manufacturing Company, et al.	On Writ of Certiorari to the United States Circuit Court of Appeals for the Sixth Circuit.

[February 5, 1945.]

Mr. Justice Douglas delivered the opinion of the Court.

The Western Tool & Manufacturing Co. is an Ohio corporation. It has outstanding some 1100 shares of stock and also bonds which total in principal amount $73,000 with large arrearages of interest. Some twenty years ago, following a default in payment of interest on the bonds, more than 50 per cent of the shares of stock were placed in a voting trust, the voting trustees being designated by the bondholders. The bonds were deposited with a bondholders' committee. The voting trustees were members of the bondholders' committee; and some of the voting trustees were also directors and officers of the company. Since the voting trust was formed the bondholders have been in control of the company. Directors have been elected by the voting trustees. In 1942 the trustee under the mortgage deed of trust filed a petition to foreclose the lien of the bondholders in an Ohio court. The court appointed one of the voting trustees receiver; and he has operated the company as a going concern since that time. The company filed its answer in the foreclosure proceeding, admitting the allegations of the bill and consenting to the appointment of a receiver. Thereafter a judgment was entered on the mortgage for some $134,000. Respondent acting on behalf of himself and other holders of shares or of voting trust receipts moved to set the judgment of the state court aside. We are told that that motion was denied. It does not appear

whether there was an appeal from that denial or whether respondent sought to intervene in the foreclosure proceedings. Respondent as owner of 7 shares of stock and as agent for owners of some 675 shares (including certain shares deposited under the voting trust) also filed a petition in the name of Western Tool & Manufacturing Co. in the District Court asking that the company be given relief under Chapter X of the Bankruptcy Act. 52 Stat. 883, 11 U. S. C. § 501. The petition stated, among other things, that the value of the assets of the company was greatly in excess of the indebtedness and that that value would be lost to the stockholders in the foreclosure action. Respondent accompanied the petition with an affidavit which stated that an unsuccessful attempt had been made to have the corporation file the petition. The affidavit set forth rather serious charges against the management of the company. It alleged that the directors were unlawfully elected and that the corporation was without a *de jure* board. It alleged that certain of the directors were occupying conflicting and inconsistent fiduciary positions, i. e. as members of the committee their fiduciary responsibility was to the bondholders, as voting trustees their fiduciary duties were to the depositing stockholders, as directors and officers their fiduciary obligation was to all the stockholders, depositing and non-depositing. It charged them with acts of mismanagement, with dissipation of the assets of the company, and with management of the company solely for the benefit of the bondholders and against the interests of the stockholders. It alleged that the voting trust was illegal and void and was no longer in effect since it had by its terms expired. And it asserted that the only way in which the value of the stockholders' equity in the company could be preserved was by reorganization in bankruptcy.

The District Court first approved the petition as properly filed. Later the bondholders' committee and the corporation filed motions to dismiss the petition on the grounds, among others, that the board of directors of the company had not authorized it. A hearing was held, following which the District Court dismissed the petition. The Circuit Court of Appeals reversed, one judge dissenting. 142 F. 2d 404. The case is here on a petition for a writ of certiorari which we granted because of the importance of the problem in the administration of the Bankruptcy Act.

Chapter X provides in § 126 that

"A corporation, or three or more creditors who have claims against a corporation or its property amounting in the aggregate to $5,000 or over, liquidated as to amount and not contingent as to liability, or an indenture trustee where the securities outstanding under the indenture are liquidated as to amount and not contingent as to liability, may, if no other petition by or against such corporation is pending under this chapter, file a petition under this chapter."

A creditor is defined in § 106(4) as the holder of any "claim". A claim is defined in § 106(1) so as to exclude stock. And a petition is defined as one filed under Chapter X by a debtor, creditors, or indenture trustee. § 106(9). It is therefore apparent that Congress has not given to stockholders the right to file petitions under Chapter X. The absence of that right is emphasized when we turn to other provisions of the chapter which define the rights of stockholders in these reorganization proceedings. When a debtor is continued in possession, a plan may be filed "by any stockholder, if the debtor is not found to be insolvent." § 170(3). Any stockholder has the right to be heard "on all matters arising in a proceeding under this chapter." § 206. And detailed provisions are included for the protection of such equity as the stockholders may have in the business. See for example § 179, § 180, § 196, § 197, § 216, § 221. Thus the rights which the stockholders are granted by the Act arise after the proceedings have been instituted. Thereafter they need not be represented solely by the debtor corporation. They may appear in their own right. Indeed, the Act contemplates their participation in the proceedings for the protection of such equity as they may have. But the initiation of the proceedings, like the run of corporate activities, is left to the corporation itself, i. e. to those who have the power of management.

These principles are not seriously questioned. And respondents make no pretense of saying that they in fact have the power of management over this Ohio corporation or that § 8623-55 of Ohio's General Corporation Act which vests the management of Ohio corporations in the board of directors[1] is inapplicable here.

[1] That section reads in part as follows:

"All the capacity of a corporation shall be vested in and all its authority, except as otherwise provided in this act or in the articles in regard to action required to be taken, authorized or approved by shareholders, shall be exercised by a board of directors of not less than three persons, which shall manage and conduct the business of the corporation."

Their theory rather is that the directors have breached their trust and have caused the corporation to commit acts which are confiscatory of the stockholders' interests, that the corporation has a defense against or a remedy in alleviation of the foreclosure action which the directors refuse to invoke, and that therefore the stockholders under the familiar rules governing derivative actions (*Dodge* v. *Woolsey*, 18 How. 331; *Davenport* v. *Dows*, 18 Wall. 626; *Hawes* v. *Oakland*, 104 U. S. 450) may proceed on behalf of the corporation. That was the view which prevailed in the Circuit Court of Appeals. But we do not think it stands analysis.

There is a misconception running through the presentation of this case which should be noted at the outset. It is a misnomer to speak of the filing of the petition on behalf of the corporation as a derivative action. A derivative action is a suit by a shareholder to enforce a corporate cause of action. The corporation is a necessary party to the suit. And the relief which is granted is a judgment against a third person in favor of the corporation. That is the rule in Ohio as well as elsewhere. 10 Ohio Juris. §§ 244 *et seq.*; *Dodge* v. *Woolsey*, *supra*; *Davenport* v. *Dows*, *supra*; *Hill* v. *Murphy*, 212 Mass. 1; *Groel* v. *United Electric Co.*, 70 N. J. Eq. 616; *Continental Securities Co.* v. *Belmont*, 206 N. Y. 7. Similarly if a corporation has a defense to an action against it and is not asserting it, a stockholder may intervene and defend on behalf of the corporation. 10 Ohio Juris. § 257; *Eggers* v. *National Radio Co.*, 208 Cal. 308; *Fitzwater* v. *National Bank*, 62 Kan. 163. Moreover, equity has evolved numerous remedies to protect not only the rights of the corporation but the interests of the stockholders as such against various acts of mismanagement. See 10 Ohio Juris. §§ 260 *et seq.*; Berle, Studies in the Law of Corporation Finance (1928). But respondents have not pursued either course. The petition which they have filed with the bankruptcy court is not a suit to enforce or protect a corporate right. Nor is it a suit to protect the interests of respondents as stockholders. Yet if it were either one, the federal District Court could not entertain it. No diversity of citizenship is shown and no other basis of federal jurisdiction is apparent. The question therefore is whether the bankruptcy court as an incident of its bankruptcy powers can give respondents the relief which, if their charges are taken as true, they might obtain in another forum. We do not think it can.

The District Court in passing on petitions filed by corporations under Chapter X must of course determine whether they are filed by those who have authority so to act. In absence of federal incorporation, that authority finds its source in local law. If the District Court finds that those who purport to act on behalf of the corporation have not been granted authority by local law to institute the proceedings, it has no alternative but to dismiss the petition. It is not enough that those who seek to speak for the corporation may have the right to obtain that authority. ~~Congress has not given the bankruptcy court power over the affairs of a corporation prior to approval of the petition.~~ The District Court in the exercise of its diversity jurisdiction would of course have the power to enforce derivative actions,[2] to make faithless directors account, and the like, where local law permits. But under the Bankruptcy Act the power of the court to shift the management of a corporation from one group to another, to settle intracorporate disputes, and to adjust intracorporate claims is strictly limited to those situations where a petition has been approved. Thus § 156 provides for the displacement of the management and the appointment of a disinterested trustee[3] in case of certain companies after approval of the petition. In other situations the court may continue the debtor in possession. § 156. The plan must include provisions "which are equitable, compatible with the interests of creditors and stockholders, and consistent with public policy" with respect to the manner of selection of directors, officers and the like. § 216(11). And the plan must likewise provide for the retention and enforcement of claims, not settled or adjusted in the plan, which the corporation may have against officers, directors, and others. § 216(13). But nowhere is there any indication that Congress bestowed on the bankruptcy court jurisdiction to determine that those who in fact do not have the authority to speak for the corporation as a matter of local law are entitled to be given such authority and therefore should be empowered to file a petition on behalf of the corporation. Respondents may have a meritorious case for relief. On that we intimate no opinion. But if they are to be allowed to put their corporation into bankruptcy, they must present credentials to the bankruptcy court showing their authority.

The jurisdiction which Congress has given the bankruptcy court over the debtor and its property prior to the approval of the petition (see sec. 111, sec. 112, and sec. 113) do not extend to this situation.

[2] See Rule 23(b), Rules of Civil Procedure.

[3] As defined in § 158.

It is argued that circuity of action will be avoided and the adequacy of stockholders' remedies will be enhanced if the bankruptcy court is authorized to entertain petitions like the present one. That may well be true. But any such enlargement of the jurisdiction of the bankruptcy courts is for Congress. It has chosen to withhold from stockholders the right to institute these bankruptcy proceedings. In absence of federal incorporation, intracorporate disputes of the character presented here are, as we have said, governed by state law. The creation of a new basis of federal jurisdiction to hear them, pass on their merits, and adjudicate them is a legislative act.

Reversed.

"A different question is presented where stockholders appear in opposition to a petition filed by the corporation. See sec. 206. Cf. In re Beaver Cotton Mills, 275 Fed. 498; Whittaker *v.* Brictson Mfg. Co., 43 F. 2d 485."